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SUBJECT: Ambassador's Farewell on Malaysian Central Bank Governor
Dr. Zeti Aziz

11. Summary: The Ambassador paid a farewell call on Malaysian Central Bank (Bank Negara) Governor Dr. Zeti Aziz on August 15. He relayed U.S. appreciation for Malaysia's efforts to combat money laundering and terrorist finance; congratulated the central bank on its successful initiatives in developing Islamic finance; and expressed hope for continued dialog on financial services and other areas of ongoing discussion. Governor Zeti expressed confidence in the Malaysian economy, particularly in becoming a global hub for Islamic finance, and her satisfaction with the level of financial inclusion, particularly among the rural poor. She cited education and training as Malaysia's biggest economic challenge, and said the GOM would be asking for assistance from foreign banks to help train Malaysians in the financial sector. She hoped U.S. companies would take advantage of Malaysian Islamic instruments to raise funds, pointing out that due to high demand for Sharia-compliant investment products, they could be offered at ten basis points lower than conventional products and still be fully subscribed. End summary.

CENTRAL BANK INTERVENES IN CURRENCY MARKET

12. The Ambassador met with Central Bank Governor Dr. Zeti Aziz on August 15, on a day when the Malaysian stock market was in rapid decline along with markets around the world. Dr. Zeti mentioned that the central bank was busy intervening to stabilize Malaysia's currency, but she seemed unperturbed about the stock market's slide. Dr. Zeti noted with some satisfaction that New Zealand had suspended its inflation targeting framework - a mechanism that the IMF had "reprimanded" Malaysia for not adopting, she said. She stated that the only reason the central bank intervened in the currency markets was to keep the ringgit stable.

ECONOMIC PERFORMANCE

13. Zeti predicted that the Malaysian economy would remain strong, in spite of the ongoing volatility in the financial markets. Malaysia enjoys a diversified economy which has benefited in particular from strong performance in the tourism, education, health, and financial services sectors. She claimed that foreign direct investment remained at high levels, and that high commodity prices were helping boost rural incomes, generating a robust domestic demand which was boosting small and medium-sized enterprises. She said many tourists were coming, especially from China, India, and the Middle East, with some from Europe as well. She pointed to Indonesia's projected six percent growth and stated confidently that, therefore, Malaysia would enjoy six percent growth as well.

GETTING ENOUGH GOOD HELP

14. Zeti noted that the Malaysian leadership recognized the need for a shift in the economy toward higher-value-added products, pointing out that the country used to be a global leader in producing air conditioners, but that such labor-intensive manufacturing ventures had moved to Vietnam and China. She said the biggest challenge to "moving on" to high-tech industries was the human resources deficit, but said the Prime Minister was pressuring the Ministry of Education to "provide the right skills." She was confident that Malaysia had the flexibility to meet this challenge. She also described efforts the GOM was making to address the human resources problem, including an initiative to sponsor internships in the financial sector for 1000 college graduates. She said the foreign banks operating in Malaysia would be asked to bring "resource persons" for a few days or weeks to help train and mentor interns. In the 1980s Citibank used to "aggressively educate" Malaysians but they don't do it on the same scale now, even though they are making a nice profit in Malaysia.

COMPARATIVE ADVANTAGE IN ISLAMIC FINANCE

15. Zeti described Malaysia's financial services sector as having transformed from an "enabler of growth" to an "engine of growth," pointing to the employment, income, and wealth the sector generated. She was excited about the potential for Islamic finance, where Malaysia had a comparative advantage. "We are now liberalized," she said, referring to a recent lifting of restrictions on the trade by Islamic financial institutions in foreign currencies, and said anyone - from Latin America, from China, or from anywhere in Asia - could raise financing here. Given the strong demand for Sharia-compliant financial products, Islamic instruments were about

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ten basis points cheaper than conventional products. She wondered if American companies would be likely to take advantage of this.

16. The Governor was optimistic about the future of Islamic banking as a global industry. She explained that the prudential standards had already been harmonized, and were comparable to Basel II. Regarding the differences in Sharia standards, she expected convergence within the next two years. (septel)

HOW MALAYSIA MOBILIZED PILGRIMAGE SAVINGS

17. Zeti credited her father for having "invented Islamic finance." She explained that her father, an economist, developed the idea for "Tabung Haji," a government-owned entity that operates as both a Sharia-compliant mutual fund and as Mecca tour operator. Her father noticed that in rural Malaysia, people saved for the Hajj (pilgrimage to Mecca) by hiding money under mattresses and in tin cans, but often lost their savings to theft, flood, or fire. Now, they can invest their savings productively through Tabung Haji which invests in various Sharia-compliant corporations and uses the money to organize Hajj tours for a long waiting list of investor pilgrims. In this way, the funds were now servicing not only their individual owners but the entire economy as well.

LIBERALIZATION VS. VULNERABILITY

18. In spite of her broad comment that Malaysia's financial sector was "now liberalized," later she qualified this, saying the government had made "many strides" in liberalization and would continue to do so, but "must manage it carefully so as not to disrupt the system." She said policymakers did not want to increase risks in light of Malaysia's vulnerabilities, and that they needed "expertise to manage (liberalization) or it would deteriorate rapidly in this environment."

MALAYSIA OUTSHINES U.S. ON ANTI-MONEY LAUNDERING

19. The Ambassador praised Malaysia's anti-money laundering and counter terrorist finance framework, citing the country's recent

Mutual Evaluation within the Financial Action Task Force Asia Pacific Group, where it ranked higher than the United States with only one recommended area for improvement (the U.S. has two). Zeti pointed out that Malaysia ranked higher than Australia as well, and credited Malaysia's mandatory identification cards and its high level of financial inclusion, especially through the voluntary Tabung Haji and the mandatory Employee Provident Fund. She recalled explaining to the G-7 that Islamic finance was not an easy instrument to finance terrorism; rather, since it was based on underlying tangible assets and required high levels of transparency for Sharia compliance, it was less vulnerable to misuse by terrorists than conventional channels.

ONLY TWO PERCENT OF MALAYSIANS "UNBANKED"

¶10. Zeti described the World Bank's studies of the "unbanked," where in many countries in Africa and Asia only 20 to 30 percent of the population has some sort of bank account. In Malaysia, 98 percent of adults had some sort of account. "We can monitor everybody!" she exclaimed happily, but then quickly added that only about three people have the codes to access individuals' account information but at least it was all in the formal sector.

¶11. COMMENT: According to Malaysia's Financial Sector Master Plan, adopted in 2001, financial services liberalization was supposed to have been achieved by 2007. Malaysia has taken incremental steps in that direction, but only within a framework that is managed meticulously from above. Bank Negara has little confidence in market forces which, along with foreigners, they generally blame for the financial crisis of the late 1990s. Underlying the excuses and the finger-pointing is a fear that local Malaysian banks cannot compete with their international counterparts. However, Malaysia is proving highly competitive in some areas of Islamic finance, and this sector could lead the way for true financial sector liberalization. If conventional finance is not blocked from following in its wake, Malaysia might be able to implement the reforms it needs to become a global player.

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